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In the Supreme Court of the United States

OCTOBER TERM, 1980

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PORTLAND CEMENT COMPANY OF UTAH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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TABLE OF AUTHORITIES

Cases:	Page
Bingler v. *Johnson*, 394 U.S. 741	7
Commissioner v. *Southwest Exploration Co.*, 350 U.S. 308	6
General Portland Cement Co. v. *United States*, 628 F. 2d 321	4, 14
Riddell v. *Monolith Cement Co.*, 371 U.S. 537	2, 4-5
Standard Lime and Cement Co. v. *United States*, 329 F. 2d 939	4, 13
Standard Realization Co. v. *United States*, 289 F. 2d 247	4
United Salt Corp. v. *Commissioner*, 40 T.C. 359	4
United States v. *California Portland Cement Co.*, 413 F. 2d 161	4, 14
United States v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76	2, 10
United States v. *Correll*, 389 U.S. 299	7, 8
Whitehall Cement Manufacturing Co. v. *United States*, 369 F. 2d 468	4, 14
Statutes and regulations:	
Internal Revenue Code of 1954 (26 U.S.C.):	
Section 611	6
Section 613(a)	6
Section 613(c)	6
Section 613(c)(4)	13, 15
Section 613(c)(4)(F)	13
Treasury Regulations on Income Tax (26 C.F.R.):	
Section 1.613-4(d)(1) and (4)	2
Section 1.613-4(d)(4)(i) and (ii)	2
Section 1.613-4(d)(3)(i), (iii) and (iv)	13
Sections 1.613-4(d)(3)(i) and 1.613-4(g)(3)	12
Section 1.613-4(d)(3)(iii)	15
Sections 1.613-4(d)(3)(iii) and 1.613-4(d)(4)(iv)	2
Section 1.613-4(d)(4)(i) and (ii)	2

Statutes and regulations—Continued

	Page
Section 1.613-4(d)(4)(iv)	2
Section 1.613-4(e)(2)	11
Section 1.613-4(e)(2)(iii)	11
Section 1.613-4(g) and (4)	13
Section 1.613-5(c)(4)(ii)	13
Section 1.613-5(c)(6)	16

Miscellaneous:

106 Cong. Rec. 13240 (1960)	13
IRS Technical Information Release 992 (Sept. 30, 1968)	9

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1. Although respondent disclaims (Br. 12) that it seeks to overturn the proportionate profits method and contends that its claimed exclusion of bagging premium income and bagging costs is simply a "modification" of the proportionate profits formula to take account of "actual facts" (Br. 17), it is plain that its argument is tantamount to an assault on the validity of the method itself.

It is undisputed that an integrated miner-manufacturer such as respondent is treated as selling the material it mines to itself. Since respondent's deple-

tion base is its constructive gross income from the *mining* phase of its operation, the income from other, post-mining processes must be eliminated from its depletion base. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86, 89 (1960); *Riddell* v. *Monolith Cement Co.*, 371 U.S. 537, 538-539 (1963). Here, respondent acknowledges (Br. 36) that there is no representative market price for the raw material upon which it claims a depletion allowance. As a result, the pertinent Treasury Regulations (Section 1.613-4(d)(1) and (4) (26 C.F.R.), Br. App. 19a-23a),[1] required respondent to compute its gross income from mining under the proportionate profits method unless it could demonstrate a more appropriate method.

As we have more fully set forth in our opening brief (at 14-17), the proportionate profits method extrapolates the integrated miner-manufacturer's gross income from mining by multiplying the gross sales of its first marketable product by the fraction of its mining costs over its total costs. The central premise of the method is that every dollar of total costs paid or incurred to produce, to sell and to transport the first marketable product earns the same percentage of the sales proceeds. Treasury Regulations, Section 1.613-4(d)(4)(i) and (ii). For an integrated miner-manufacturer of cement, Section 1.613-4(d)(4)(iv) of the Regulations provides that cement is its first marketable product. In accordance with the underlying assumption of the proportionate profits method, Sections 1.613-4(d)(3)(iii) and 1.613-4(d)(4)(iv) of the Regulations provide that the gross sales of cement, including that sold in bags, and the

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[1] "Br. App." refers to the appendix to our opening brief, which sets forth the statutes and regulations involved.

costs of bags and bagging incurred in selling cement were to be included in the proportionate profits equation. The exclusion of any part of gross sales or the costs incurred to produce gross sales will distort the underlying method, with the result that the depletion allowance will not be restricted to its intended ambit, *i.e.*, to compensate the miner for the exhaustion of his mineral assets.

a. Respondent, however, argues (Br. 10-12, 15-32) that because the premium it charged for bagged cement did not cover the bagging costs, the bagging premium and the bagging costs should be excluded from the formula. In respondent's view, the failure to exclude the bagging premium and bagging costs distorts the true market value of its raw material and results in a less favorable depletion allowance than is available to those who sell cement only in bulk.

But respondent's argument rests upon the erroneous assumptions that bulk cement and bagged cement are two different products, and that bagging costs produced only the additional revenue derived from the bagging premium. Respondent's cement is indisputably the same product, whether sold in bulk or in bags (J.A. 40). Moreover, the stipulated fact is that respondent "realized a net profit on the sale of each bag of cement" (J.A. 103). It is plain that respondent undertook to pack cement in bags in response to a particular customer demand for bagged cement. These customers would not have purchased the cement if respondent had not packed it in bags. Hence, for these customers, bagged cement is respondent's first marketable product. As we stated in our opening brief (at 21, 29), it is therefore reasonable to infer that the bagging costs contributed to respondent's

profits.[2] Accordingly, both the bagging premium and

[2] Apart from the decision below, the courts have uniformly concluded that bagging costs did not simply produce an equivalent amount of bagging premium income. Rather, the courts have held that bagging costs produced profits in the sale of cement and that such profits were not properly a part of gross income from mining. Hence, the inclusion of such costs as nonmining costs in the proportionate profits method will eliminate the profits from the depletion base attributable to bagging costs. See *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468, 474 (3d Cir. 1966); *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 169 (9th Cir. 1969); *General Portland Cement Co.* v. *United States*, 628 F.2d 321, 330-333 (5th Cir. 1980); and *Standard Lime and Cement Co.* v. *United States*, 329 F.2d 939, 949 (Ct. Cl. 1964). Respondent concedes (Br. 29-30) that in these cases, the bagging costs either were the same as the bagging premiums or, as in the instant case, exceeded the bagging premiums. Yet in each case, as here, the taxpayer made a net profit on the sale of each bag of cement.

The amicus curiae relies (Br. 12-14) on a number of cases (*e.g.*, *United Salt Corp.* v. *Commissioner*, 40 T.C. 359 (1963), aff'd, 339 F.2d 215 (5th Cir. 1964); *Standard Realization Co.* v. *United States*, 289 F.2d 247 (7th Cir. 1961)), which stand for the proposition that the costs of bags and bagging are nonmining costs in determining the cutoff point at which mining ceased. But those cases are distinguishable. As the Fifth Circuit in *General Portland Cement Co.* v. *United States*, *supra*, 628 F.2d at 332-333, and the Ninth Circuit in *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 169, correctly pointed out, those cases did not involve the application of the proportionate profits method to integrated producers. Rather, they involved determinations of the "commercially marketable * * * product" of the mining processes of nonintegrated miners in accordance with the representative price method. Most of these decisions took into account this Court's decision in *Cannelton* that a raw mineral is a commercially marketable product when it is suitable for industrial use and consumption, and can be shipped for such use, whether or not it can be sold at a profit. In *Riddell* v. *Monolith Ce-*

the bagging costs must be included in the proportionate profits equation in gross sales and total costs, respectively.

Indeed, there is no difference in function between the costs of loading a railroad car and the costs of loading a bag. The loading of the cement into a railroad car or bag, is not, as the amicus would have it (Br. 3, 11-12), further processing. Processing, as the amicus concedes (Br. 11), is an operation that alters the physical or chemical characteristics of the product. Bagging, on the other hand, is simply an operation designed to put the cement into the hands of the customer in the desired manner, *i.e.*, making available the first marketable product. Respondent does not argue for exclusion of the costs of loading its bulk cement into a railroad car. Bagging cement

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ment Co., 371 U.S. 537 (1963), this Court held that limestone has reached this state when it is crushed. In such a case, bagging of the limestone would not be a mining process because the "commercially marketable" product was simply the crude mineral resulting from mining processes, which were then defined by statute as "the ordinary treatment processes normally applied by mine owners or operators". Accordingly, those cases properly hold that bagging the crude mineral was a post-mining operation, and the costs of bagging could not be reflected in the taxpayer's depletion base. There is no representative market price for kiln feed, the cut-off point product, and, therefore, the proportionate profits method must be used. The first marketable product is cement, made ready for the customer in the form he desires, either in bulk or in bags. Under the proportionate profits method, no cost of producing and selling cement can be excluded from the formula.

The amicus disputes (Br. 20) our inference that respondent sold the bagged cement in response to customer demand. But neither it nor respondent offers any other reason for respondent's bagging expenditures. Indeed, the silence of the record that the amicus cites (*ibid.*) does not support respondent's claims since it bore the burden of proof in this Tax Court proceeding.

is a comparable operation for a significant quantity of respondent's sales. Surely both costs were necessary to sell its first marketable product, viz., cement. Hence, both costs must be included as non-mining costs in the proportionate profits formula.

Moreover, respondent's argument that the proportionate profits method as applied distorts the true market value of its mined material overlooks the fact that Congress has tied the percentage depletion allowance to *income* actually or constructively received from mining operations, without regard to the value of the mineral. Section 613(a) and (c) of the Code (26 U.S.C.). See also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956). Indeed, the proportionate profits method is required to be employed in the instant case precisely because there is no evidence from which respondent's gross income from mining could be computed.[3]

b. Second, there is no evidence to support respondent's uncorroborated assertion (Br. 23-24) that it received a less favorable depletion allowance than those who sell cement in bulk, or that the application of the proportionate profits method as set forth in the Treasury Regulations distorts its depletion allowance.[4] Section 611 of the Code authorizes the deduc-

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[3] Respondent's reliance (Br. 18 n.13) upon the decisions involving the so-called "sudden death" rules that all processes following the first nonmining process must be treated as nonmining processes is misplaced. Unlike the instant case, where respondent seeks to invalidate Regulations which explicitly provide that bulk *and* bagged cement is the first marketable product, those cases involved competing interpretations of Regulations that are not at issue in this case.

[4] Respondent also argues (Br. 4, 7, 22) that the proportionate profits method distorts its gross income from mining because it mines a unique type of cement rock which has a

tion of a reasonable allowance for depletion "according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate." Under this congressional authorization, the Commissioner of Internal Revenue chose the proportionate profits method to compute gross income from mining for depletable hard minerals in the absence of a representative market price or in the absence of a more appropriate method. As we pointed out in our opening brief (at 8, 19-20), this Court has held that the legislative Regulations adopted by the Commissioner in the multifarious circumstances involving questions of depletion are entitled to special deference. "In this area of limitless factual variations, 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.' " *Bingler* v. *Johnson*, 394 U.S. 741, 751 (1969), quoting from *United States* v. *Correll*, 389 U.S. 299, 307 (1967). The Commissioner has reasonably determined by Regulation that cement, whether in bulk or in bags, is the first marketable product, and that bagging premiums and bagging costs must be included in the proportionate profits equation.[5]

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high value as a raw material for use in the manufacture of portland cement and because its mining operations are cost-efficient. There is no factual basis to support either argument. But even on the assumption that respondent mined a valuable limestone material used in the manufacture of portland cement from 1954-1956, these assertions have no relevance as to whether its bagging premium and the bagging costs should be included in the proportionate profits method for 1970-1972.

[5] The amicus argues (Br. 24 and App. B-1 to B-3) that the application of the proportionate profits method as set forth in the Regulation attributes part of the bulk sales to bagged

To be sure, the proportionate profits method is an approximation of gross income from mining. But the absence of a market price for the mineral in question necessarily requires that some method of approximation be used in determining constructive income. The Commissioner's proportionate profits method represents a reasonable implementation of the statutory authorization. Under this method, the taxpayer's gross income from mining depends upon its mining and nonmining costs incurred in making its gross sales of cement. Of course, these costs will vary from taxpayer to taxpayer. And it might well be that a taxpayer selling cement only in bulk would have less gross income from mining than a taxpayer selling cement in bulk and in bags or only in bags. At all

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sales. But if the costs of bags were excluded from the equation, the profit that they generate in selling cement would be attributable to bulk sales. Because those costs indisputably contribute to respondent's profit from the sale of cement, they must be included in the proportionate profits equation. All the amicus' argument proves is that there are various ways in which the Commissioner might have constructed the proportionate profits method. As an approximation, the proportionate profits method is not perfect. But since Congress gave the Commissioner the power to determine the reasonable allowance for the depletion deduction by Regulation, the Commissioner's choice must be approved as long as it is reasonable. The fact that the amicus has suggested an alternative computation—involving two fractions rather than a single fraction—that produces a greater depletion allowance and that might also be deemed reasonable, is an insufficient basis upon which to invalidate the Commissioner's method. "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *United States* v. *Correll, supra,* 389 U.S. at 307.

events, respondent cannot claim that the Regulations treat it unfairly, since all similarly situated integrated miner-manufacturers are treated exactly the same.[6] The Regulations permitted respondent to come forward with another method to construct its gross income from mining. But it chose to rely upon the proportionate profits method. Once having done so, respondent may not engage in selective implementation of the proportionate profits formula in a manner designed to increase its depletion allowance. The mathematical integrity of the formula demands that it take into account all gross sales and costs incurred in producing the first marketable product. Hence, bagging premium income and bagging costs must be included in respondent's gross income and nonmining costs.[7]

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[6] There is no basis for the amicus' argument (Br. 23) that the Regulations treat respondent less favorably than a taxpayer under the representative price method. Such a comparison is not valid. The essential point is that the proportionate profits method must be employed only because there is no representative price for the mined ore that would justify use of the representative price method. Thus, all similarly-situated taxpayers throughout the integrated cement industry are subject to the application of the proportionate profits method.

[7] Respondent contends (Br. 12, 25-26) that the proportionate profits method as set forth in the Regulations may be modified by the courts because the Commissioner has determined that such method is inapplicable in constructing the gross income from mining in the case of oil and gas. But the oil and gas industry demonstrated to the Commissioner that other methods were more appropriate to construct the gross income from the property than the proportionate profits method. Unlike the cement industry, the costs incurred in the oil and gas industry to produce, sell, and transport the first marketable product are not substantial compared with the product's gross sales. See IRS Technical Information Release 992 (Sept. 30, 1968). Respondent, as well as the integrated

2. Respondent further argues (Br. 10, 14-16, 21) that the Commissioner's application of the proportionate profits method in this case is contrary to this Court's decision in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960). In *Cannelton*, the Court determined the cut-off point for mining under the pre-1960 statute. In making this determination, the Court indicated that an integrated miner-manufacturer is entitled to depletion only on his constructive income from the raw mineral product of "mining." The Court did not address the question presented here as to how an integrated miner-manufacturer's constructive income from mining should be computed under the proportionate profits method. Thus, in *Cannelton*, the Court did not hold that the percentage depletion base could not be computed under a cost-ratio method such as the proportionate profits formula. It simply ruled that the representative market price had to be used in that case even though it had no relationship to taxpayer's mining costs and failed to provide taxpayer with a profit.

For more than 40 years, the Regulations have prescribed the proportionate profits method for computing the gross income from mining of integrated miner-manufacturers. That method is wholly in accord with the statute and with *Cannelton*. Under the statute, the depletion allowance is a percentage of gross income from mining. *Cannelton* limits an inte-

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cement industry as a whole, had the same opportunity to make a similar demonstration. But they have not done so. At all events, the fact that the proportionate profits method is not employed in constructing the gross income from oil and gas extraction does not support respondent's argument that the proportionate profits method should be modified with respect to the bagging premiums and bagging costs of integrated producers of cement.

grated producer to depletion on his constructive income from constructive sales of the mining product to himself. Under the proportionate profits method, this constructive income is derived from actual figures—the taxpayer's gross income from sales of its manufactured product (cement) and its costs of producing and selling that product.

3. Contrary to respondent's further argument (Br. 12, 24-25), the bagging costs in this case are not analogous to the costs of purchased transportation to the customer, which Section 1.613-4(e)(2) of the Regulations permits to be excluded from the proportionable profits formula. See Br. App. 12a-15a. That Regulation deals only with nonmining transportation of a taxpayer's finished products to the customer where: (1) the transportation is made in conveyances owned by a party other than the taxpayer, (2) the transportation is solely a function of delivery of the purchased products to the customer rather than a function of transporting the taxpayer's minerals or unfinished cement for packing or other additional processing by the taxpayer (other than incidental storage or handling), and (3) the taxpayer can show that these costs do not ordinarily earn any profit.

Purchased transportation to the customer represents a cost which may be viewed as producing a profit, not to the cement miner-manufacturer, but rather to the transporter. Section 1.613-4(e)(2)(iii) of the Regulations specifically contemplates an arm's-length charge ordinarily paid by shippers of the product in similar circumstances. The Regulation permitting exclusion of the costs of purchased transportation to the customer represents an administrative determination that such costs, incurred under

the narrowly circumscribed requirements of the Regulation, do not produce a profit to the taxpayer. Here, on the other hand, bagging costs, incurred by respondent to make sales to customers who will buy only bagged cement, did in fact produce a profit to respondent (J.A. 103). Hence, bagging costs are not comparable to transportation costs paid to a third-party.

Indeed, the more appropriate analogy would be to Treasury Regulations, Sections 1.613-4(d)(3)(i) and 1.613-4(g)(3), Br. App. 16a-18a, 25a-26a, which deal with transportation costs other than purchased transportation of the finished product to the customer, such as transportation of ore to processing plants, or to marketing or distribution centers. Such costs are regarded as producing a profit to the miner-manufacturer. Hence, as in the case of bagging costs, these transportation costs are classified as either mining or nonmining within the context of the proportionate profits formula.

4. With respect to the second question presented, respondent apparently agrees with the Commissioner that the court below erred in excluding from the proportionate profits equation the costs of storing, shipping and selling and, if gross sales of cement sold in bags are included, the costs of bags and bagging. But respondent claims (Br. 12-13, 33-39) that these costs benefit the entire mining-manufacturing operation and should be allocated between mining and manufacturing operations in the costs fraction of the proportionate profits formula rather than included in the denominator as non-mining costs.

Apart from the fact that there is no factual foundation for respondent's assertion that such costs benefitted its entire operation, the argument is fore-

closed by Section 613(c)(4)(F) and the controlling Treasury Regulations (Section 1.613-4(d)(3)(i), (iii) and (iv), 1.613-4(g)(3) and (4), and 1.613-5 (c)(4)(ii) (see our opening brief, at 24, n.10, and Br. App. 5a, 16a-19a, 25a-26a)). Section 613(c)(4)(F) provides that in the case of minerals used in making cement, mining includes all processes up to kiln feed "but not * * * any subsequent processes." Subsequent manufacturing and marketing processes incurred after kiln feed are classified as nonmining costs. The function of Section 613(c)(4) was, as the sponsor of the provision stated, "to preclude the interpretation of the term [mining] as including operations involved in processing the finished product, the packaging, and the shipping of the finished product" (106 Cong. Rec. 13240 (1960)). Thus, in *Standard Lime and Cement Co.* v. *United States*, *supra*, 329 F.2d at 946-947, the Court of Claims correctly stated:

> We believe that Congress intended to include in gross income from mining only those cost items (and a percentage of the entire profit attributable to them) which were incurred for the benefit of the mining operations as defined in section 613(c)(4). This result is inescapable since we must view depletion as "an allowance for the exhaustion of a capital asset." United States v. Cannelton Sewer Pipe Co., supra, 364 U.S. at 86, * * *. This capital asset under the statutory definition is measured for depletion purposes in terms of "gross income from mining." It follows that only those costs incurred for the benefit of the mining operation as particularized by the statutory scheme, can be included. The language of subparagraph (F) of subsection 613(c)(4) demands this conclusion,

> for it specifically includes all processes up to kiln feed "but not including *any subsequent processes*. [Emphasis in original.] We interpret this as excluding any subsequent manufacturing or marketing processes. * * * [W]e must view the miner-manufacturer as selling to itself the processed minerals at the kiln feed stage. United States v. Cannelton Sewer Pipe Co., supra, 364 U.S. at 87 * * *. Thus taxpayer, the miner, does not incur those subsequent costs which its alter ego (the manufacturer and distributor) must incur to sell the end product. To view this in any other perspective would introduce the tax discrimination between integrated and non-integrated miners against which the whole tenor of the Cannelton decision was directed.

Accord: *General Portland Cement Co.* v. *United States, supra*, 628 F.2d at 333-335; *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468, 473 (3d Cir. 1966); *United States* v. *California Portland Cement Co., supra*, 413 F.2d at 169.

In a general sense, all of an integrated cement producer's costs, mining and nonmining, can be said to benefit its entire operation directly or indirectly. Both its mining and its nonmining costs are directed to the same ultimate goal, the sale of finished cement at a profit. That does not mean that recognized mining costs should be allocated in part to nonmining. By the same token, the costs of marketing the end product, which are recognizable nonmining costs, should not be allocated to mining. Only costs that benefit both phases of the producer's operation and are not directly identifiable with either a particular mining process or a particular nonmining process may be apportioned between mining and nonmining

expenses. Treasury Regulations, Section 1.613-4(d)(3)(iii), Br. App. 20a.

Here, the costs of bags, bagging, storage, distribution and sales have no functional relationship to respondent's mining activity and are incurred in the marketing processes long after the mining processes, as defined by the statute, have ceased. In accordance with the statute, the controlling Regulations provide that each of these costs are includible in the formula as nonmining costs. Indeed, in accordance with the statute and the rationale expressed by the Court of Claims, every court that has considered the costs of bags, bagging, storage and distribution has considered these costs to be nonmining costs (see our opening brief, at 24-25).

To be sure, some courts have held that selling costs should be allocated between nonmining and mining income. But as we have pointed out in our opening brief (at 25-26, n.13), those decisions antedated the 1972 Regulations that now explicitly provide that such selling expenses are nonmining costs absent a showing that nonintegrated miners incur the same costs. Since these costs relate to the marketing process of selling the finished cement, they are incurred long after the mining processes have ceased and have no functional relationship to them. Hence, under Section 613(c)(4), they must be treated as nonmining expenses. However, when it can be shown that nonintegrated miners incur selling costs to sell the raw materials, then the costs of selling may be allocated between mining and nonmining, in order to put the integrated miner-manufacturer on the same tax basis as the nonintegrated miner.[8] However, where,

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[8] Respondent's reference (Br. 33, 37) to trade association dues is misplaced. The parties agreed that the trade association dues were allocable between mining and nonmining costs

as here, there are no nonintegrated miners, then no part of the selling costs may be allocated to mining operations.[9]

To apportion all of respondent's costs involved between mining and nonmining, as it urges, would not only require the invalidation of the controlling Regulations, but would allocate part of the costs associated with nonmining processes and their related proceeds to the depletion base. What respondent seeks is nothing less than an expansive depletion allowance covering part of its nonmining income derived from marketing its manufactured end product. This Court should reject such an attempt to extend the depletion allowance beyond its intended purpose of compensating for the exhaustion of the mineral asset.

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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Solicitor General

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in accordance with Section 1.613-5(c)(6) of the Treasury Regulations (26 C.F.R.) on the theory that these dues benefitted both mining and nonmining processes rather than any particular process. The selling costs dealt only with the selling of the finished cement.

[9] The pre-1972 decisions permitting allocation of selling costs between mining and nonmining are not inconsistent with the 1972 Regulations. They assumed a fact that the Regulation requires to be proved. See our opening brief, at 25-26, n.13.

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